July · 1934

Bulletin

THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

LEGAL RELATIONSHIP *of an* ACCOUNTANT *to an* INVESTOR

INVESTMENT BANKING PHASES *of the* FEDERAL SECURITIES ACT *and* SECURITIES EXCHANGE ACT

The VALUE OF INDEPENDENT AUDITS *and* WHAT THE BANKER EXPECTS *of the* ACCOUNTANT

OFFICE OF THE SOCIETY
30 BROAD STREET · NEW YORK

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"To cultivate, promote and disseminate knowledge and information concerning accountancy and subjects related thereto; to establish and maintain high standards of integrity, honor and character among certified public accountants; to furnish information regarding accountancy and the practice and methods thereof to its members, and to other persons interested therein, and to the general public; to protect the interests of its members and of the general public with respect to the practice of accountancy; to promote reforms in the law; to provide lectures, and to cause the publication of articles, relating to accountancy and the practice and methods thereof; to correspond and hold relations with other organizations of accountants, both within and without the United States of America; to establish and maintain a library, and reading rooms, meeting rooms and social rooms for the use of its members; to promote social intercourse among its own members and between its own members and the members of other organizations of accountants and other persons interested in accountancy or related subjects; and to do any and all things which shall be lawful and appropriate in furtherance of any of the purposes hereinbefore expressed."

—From the Certificate of Incorporation.

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171

July · 1934

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TABLE OF CONTENTS

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Legal Relationship of an Accountant to an Investor

By H. Theodore Sorg, Senior Partner
of SORG, DUNCAN & BAILEY

THE accounting and legal professions are in many respects closely akin. Today, perhaps more than ever before, the accountant requires legal training and the lawyer without accounting knowledge is under a decided handicap.

My first knowledge of the existence of the accounting profession was acquired as a youngster, some forty years ago. The principal of our public school, a dour and hardbitten individual, whom none of us liked, quit his position and accepted appointment as municipal comptroller. Several years later came the startling news that he had decamped with some fifty thousand dollars of the city's money. We all hoped for the worst but, unfortunately, unlike modern financiers, he selected as his future permanent residence a foreign country from whence there was no extradition. While the excitement was at its height, the newspapers reported that the city had engaged the services of a certain accounting firm in New York in the matter. Just what that involved we did not know until an older boy with superior wisdom stated: "Oh, they are the people called in when a man steals something, to find out how much he stole!"

I presume, however, that if today some bright young student were asked to define an accountant, he would reply: "He is the person held responsible in case of liability under the Federal Securities Act."

The scope of my address today is limited to consideration of the development to its present status of the legal relationship of the accountant to the investor. It may be said that that legal relationship up to the present time has passed through three stages: First, as generally conceived prior to the Ultramares case; second, as defined in the Ultramares case and third, as extended under the Securities Act of 1933.

Prior to the Ultramares decision the accountant conceived that he had little to fear in his legal relationship to an in-

vestor. His liability was apparently limited by his contract with his employer client. Investors who purchased stock in the client corporation, or creditors who became such relying on the certification of the accountant, were strangers to him. There was no privity of contract between them; hence apparently no duty; therefore no liability, regardless of the negligence of the accountant in making his examination and certification. Possible liability on the ground that the accountant had made his report with intent to deceive the investor seemed far fetched and remote.

Nor was the accountant in any great danger so far as his employer was concerned. True, there was privity between them, hence possible liability for the accountant's negligence. But even that was subject to all manner of limitations and defenses. For example, the accountant was dealing with a client who was almost as well informed and sometimes better informed than himself concerning the true financial picture and hence could not prove that he had been misled; again the accountant's certification was in any event largely a matter of opinion, with the resultant latitude that accompanies any opinion. Moreover, the accountant might avail himself of the defense that he had been misled through negligence or concealment of the client or the latter's employees; also that the scope of the employment did not contemplate liability for the matters complained of by the client, and so on, world without end. The very fact that responsible and experienced insurance companies gladly issued policies of insurance in huge amounts at comparatively low premiums against the risk of such liability is itself evidence that such possible liability was not causing deep concern.

Stresses Importance of Ultramares Decision

Then, in the year 1931, came the Ultramares decision in New York, (255 N. Y. 170). It should be noted in passing that Justice Cardozo (now Justice of the United States Supreme Court) who wrote the opinion as then Chief Justice of the Court of Appeals of New York, is universally recognized as one of the ablest judges on the bench today. From a legally academic viewpoint, he might be deemed subject to criticism in that he attributes greater importance to human

rights than he does to legal precedent. Yet despite, or perhaps more exactly because of, the fact that he permits enlightened justice to outweigh, or extend the scope of, established precedent, his opinions have a tendency to become the bed rock of modern law on the particular subject considered.

There has been much discontent on the part of accountants with the Ultramares decision, partly due, perhaps, to failure to accurately appraise that decision or the facts on which it rests.

For example, it has been said that the Ultramares case would, apparently, have been finally decided in favor of the accountants by the Court of Appeals of New York if the accountants concerned had not stated as a fact that the balance sheet which they certified was in accord with the books of the company; that doubtless they thought this was a fact, and that doubtless it was a fact in the sense in which they meant the language to be interpreted, namely, that the balance sheet was in accord with the general books and that obviously the question of whether a balance sheet agrees with the books must always be in reality a matter of opinion, if for no other reason than because no accountant can be sure that he has seen all the books that exist.

In the first place, if it was intended merely as an expression of opinion and not as an unqualified statement of fact, it would have been a simple matter to have so stated. Is it not a fact, that a besetting sin of all of us is the careless use of language which fails to express our real meaning? That sin is not confined to accountants or lawyers but is common with business and professional men of all classes and extends as well to judges and to legislative bodies. Probably half of our litigation could be avoided if human beings attained to the art of accurately setting forth their actual intentions.

Moreover, the conclusion is not justified that the result in the Ultramares case would have been different had there been no such unqualified statement of fact that the balance sheet was in accord with the accounts. For in addition to that statement there was the usual statement of accountants that the accounts had been examined, which was

followed by the certification that in the opinion of the accountants the balance sheet presented a true and correct view of the financial condition of the company.

Summarizes Opinion of Court

Under the particular circumstances of that case, and with regard to the question of a possible inference of constructive fraud, the court held:

> (a) Even an opinion, especially an opinion by an expert, may be found to be fraudulent if the grounds supporting it are so flimsy as to lead to the conclusion that there was no genuine belief back of it.
>
> (b) Where accountants certify matters as facts true to their own knowledge, and their statement is false, they are not to be exonerated because they believed them to be true.
>
> (c) Although negligence of an accountant in certifying agreement between the balance sheets and the accounts is not per se and as a matter of law equivalent to fraud, nevertheless such negligence, at least if gross, constitutes evidence from which a jury *may* draw an inference of fraud.
>
> (d) If it be found that the accountant made a statement as true to his own knowledge when in fact he had no such knowledge, then the accountant may also be found to have had no basis for a sincere or genuine opinion that such was the fact for fraud includes pretense of knowledge when knowledge there is none.
>
> (e) Where the circumstances are such as to constitute notice to the accountant that his employer does not intend to keep the report and certification of the accountant to himself, the duty of the accountant to make his certificate without fraud extends to the creditors and investors to whom the employer exhibits the certificate.

In connection with the foregoing, it should be borne in mind that in order to recover in an action for fraud, proof is required not merely of the making of a representation knowingly false with the intention that it be relied on, but also that it was in fact so relied on to the plaintiff's damage.

There was also involved in the Ultramares case the question whether mere negligence of an accountant, though insufficient to justify an inference of fraud, might yet be the

basis of liability to third parties injured thereby, who did not stand in privity to the accountant but to whom it was reasonably to be expected they would be communicated. Or, as stated by the court, whether "words, written or oral, if negligently published with the expectation that the reader or listener will transmit them to another, will lay a basis for liability though privity be lacking." The court held that that doctrine was not the law and added that "a change so revolutionary, if expedient, must be brought by legislation."

Perhaps the foregoing enunciation of principles and particularly the last quoted statement, pointed the way to the Securities Act. However that may be, the fact remains that under the Securities Act negligence, though insufficient to justify an inference of fraud, may yet result in liability of the accountant to any purchaser of the security issued pursuant to the registration statement, which included the certification of that accountant.

Sees Added Responsibility Under Securities Act

Moreover, Congress has gone far beyond the Ultramares decision in that under the Securities Act:

(a) the investor need not have had any knowledge of the registration statement or the fact that it included the accountant's certification;

(b) he need not prove reliance thereon;

(c) he can recover his loss up to the full amount at which the security was offered to the public;

(d) he need not prove any relation between the accountant's negligence and his loss;

(e) the burden of proving that the investor knew the true situation at the time of his investment is placed on the accountant;

(f) the investor has two years after discovery or opportunity for discovery of the untrue statement or omission in which to bring his action and ten years after the security was offered to the public within which to make such discovery and institute action;

(g) in determining what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness is that required of a person occupying a fiduciary relationship.

To a certain extent the accountant is himself responsible for his present predicament. Starting out originally as a public bookkeeper and then as a public auditor of other persons' bookkeeping, his field of activity has gradually extended until today he performs not only those functions but also those of business adviser, financial adviser, potent factor in the sale and distribution of securities, appraiser, quasi lawyer (at least in income tax matters) and (whether correctly or not) has gradually created the impression that he is an indispensable adjunct to all business and financial transactions. The one function, however, which he has neither sought nor desired, but which the government now apparently seeks to force upon him, unless he is wise enough to properly qualify his certification, is that of quasi insurer to the investing public of securities issued under registration statements. The legal profession gracefully concedes to the accounting profession this post of responsibility.

Unfortunately for the accountant, the public, the courts and Congress, fail to make the nice discriminations between an expression of opinion by the accountant and a certification of fact. The impression persists that when the accountant certifies he is certifying to facts instead of merely expressing an opinion based on application of accepted accounting practices to a collection of data which may or may not constitute facts.

Expression of Opinion and Certification of Fact

That application by the accountant of accepted accounting practices to the facts disclosed by his investigation, whether resulting in a certification of fact or merely in an expression of opinion is unlikely soon to attain the status of an exact science, was vividly demonstrated a few days ago in the announcement of suit about to be instituted against the directors of a moving picture corporation based on their alleged impairment of the capital of the corporation through purchase by the corporation of its own stock. As a result of application of accepted accounting practices by at least four leading firms of accountants, apparently based on the same data, these four different results were obtained: One accounting firm advised that there was an impairment of

capital to the extent of more than eleven million dollars; another that the capital impairment was merely some three million dollars; another that no impairment of capital was disclosed; the fourth that the consolidated earned surplus after the stock purchase was more than eighteen million dollars.

With variations of such large amount, it would seem that there must have been ample room for divergent views as to the treatment of items such as possibly allowances for depreciation, losses to be written off or other items that would affect the surplus. The very fact, however, that there is the possibility of such widely divergent views among accounting firms of reputable standing demonstrates the utter folly, not merely of certifying the correctness of such items as fact, but even of certifying to an unqualified opinion based thereon.

So long as the accountant is under necessity of certifying that after reasonable investigation he has reasonable grounds to believe and does believe at the date of his certification that, except as specifically noted, the statements contained in the balance sheet, and profit and loss statement attached to his certificate truly and fairly reflect the application of accepted accounting practices to the facts disclosed by his investigation and that there is no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading to the investor, the only safe course for the accountant to pursue is to fully and completely set forth as qualifications and exceptions to his certification, matters that are not within his personal knowledege.

It may result that in a given case the exceptions and qualifications may constitute the major portion of his certification. James M. Landis, member of the Securities and Exchange Commission, recently pointed out that in one registration statement filed, the certification totalled in excess of thirteen hundred words, probably most of which constituted exceptions and qualifications. Compare such a certification with the form of certification commonly used prior to the Securities Act, as for example that in the Ultramares case which totalled less than eighty words.

If an accountant properly and fully sets forth in his certification the qualifications and exceptions concerning such matters which are outside his personal knowledge, those qualifications and exceptions, so far as the investor is concerned, may constitute the most valuable and important part of the certification. For if accurately presented they will indicate to the investor that those items are subject to question, the answer to which may affect the safety of his investment.

Urges Qualifications in Certificates

Nowhere in the Securities Act or regulations do I find any provision requiring the accountant to certify to matters not within his knowledge, or which prevents him from so qualifying his certification as to confine the same within the scope of that knowledge, even though the result may be to render the certification valueless so far as suits by disgruntled investors against the accountants are concerned.

Emphasis cannot be too strongly laid, even at the risk of seeming repetition, on the urgent need for the accountant today to confine his certification both of fact and of opinion strictly to matters within his knowledge, and the vital importance of inserting exceptions and qualifications with adequate explanation on every matter not within his knowledge to which his certification would pertain.

The accountant today has several alternatives open to him.

(a) He can refuse to accept any engagements whatsoever which will involve certifications for registration purposes. However, unless this be done by the accounting profession as a unit (which is practically impossible) the result is likely to be disastrous to the business of the particular accountant.

(b) He can seek to be indemnified by the client for the liability to which he is subjected by the Act. This, however, is at best a makeshift, for if the client's financial position once reaches the point where it becomes necessary for the investor to sue the accountant for the amount of his investment, the value of the indemnity is not likely to amount to very much.

(c) He can continue to certify, without regard to consequences, until finally wrecked financially by the suits of such

security purchasers. In that case it becomes simply a question of time as to when the bankruptcy petition of the accountant will be filed.

(d) He can reduce his liability to a minimum and bring it to within at least fairly reasonable bounds, by insertion of proper exceptions and qualifications in his certification. As a matter of fact, under those circumstances he will probably continue in business for a long time, for after all the likelihood is that the great majority of suits brought under the Act will be based on the very items which can properly be covered by qualifications and exceptions and which will absolve him, at least, from joint liability therefor.

Some Subjects of Qualification

A number of situations are selected at random as properly the subject of qualification and exception:

1. Where the assets include realty the accountant should qualify his certification to eliminate certification of title and freedom from liens and encumbrances, all of which are strictly matters of law.

2. Like qualification should be made with regard to any other substantial items such as patents, patent rights, trade marks, leaseholds, mining rights, oil rights, etc., the value of which may be entirely dependent upon legal analysis.

3. Similarly, no report or certification should be made as to the propriety of actions or investments of the client which are dependent upon legal construction of the corporate charter, or of any agreement or trust. On occasion, published reports prepared by accountants have included statements that the corporation under its charter had the right to do thus and so, or that under certain agreements it had the right to make this or that investment, etc. One stated that "the trustees in their discretion under the declaration of trust may include the stock dividend as earnings." There would seem to be no occasion for accountants to rush in where angels or even lawyers might fear to tread.

4. There should be no unqualified certification with respect to valuation of plant and equipment and inventory, adequacy of reserves or allowances for depreciation unless

and until there are, and they fully meet, standards generally accepted as determining such valuations or reserves and the items are sufficiently described in the statements to indicate clearly the basis on which they are included therein. It should not be stated that the valuations represent cost when in fact the property was acquired in exchange or part exchange for stock, the cash value of which may have been problematical. In any event the accountant should be careful to avoid certifying in such a way as to assume the responsibility of the engineer or appraiser for to do so invites litigation.

5. Where assets include blocks of stock, the value of which on the balance sheet is based on the then current market price per share, it should not be overlooked that the actual value is dependent upon the ability of the market to absorb that quantity of stock at such current price. Hence, instead of merely describing or certifying such valuation as "market value" it should be described as "priced at current market quotations or bid prices," and if the quantity of stock is large, the certification should be made dependent upon the ability of the market to absorb it at the current price.

It may be argued that inclusion of such exceptions and qualifications renders an accountant's certification valueless. The obvious answer is that omission of such exceptions and qualifications does not add any value to the certification as such, if in fact the accountant has no knowledge of the particular matter. Nor will a qualification avail the accountant as a substitute for reasonable performance of his legitimate function. Suppose the accountant noted in his certification that he had not verified the accounts receivable. That might merely constitute an admission on his part that he had not properly completed his task.

About Clients' Objections to Qualifications

The objection may also be raised that inclusion of such exceptions and qualifications are objectionable to the client. The answer is three-fold. First, the client should not and if he is reasonable will not, demand that the accountant assume liability for something which is the province of others. Second,

the client, if intelligent, will realize that in protecting himself, the accountant is also protecting the client to the extent that such exceptions or qualifications are notice to an intending investor of the possibility of a divergence of opinion on the matters excepted. Third, if notwithstanding, the client insists that the accountant assume such responsibility, it may be advisable to decline that engagement.

It is significant to note the recent widespread demand by directors of corporations, that they be exempt from liability if they reasonably and in good faith relied on the accountant's certification. One can sympathize with the desire that the accountant act as buffer between the investor and the director. If, however, the accountant is to bear the brunt of attack, he should at least be entitled to equip himself with a few shock absorbers.

There is now pending enactment by Congress, the proposed Federal Securities Exchange Act of 1934, regulating stock exchanges, providing for their registration as national securities exchanges and providing also for the registering of securities traded thereon except as exempted by the Act. So far as the accountant is concerned, the provisions of the Exchange Act are far less onerous than similar provisions of the Securities Act.

The security registration requirements of the Exchange Act include the filing of balance sheets and profit and loss statements for not more than three fiscal years preceding registration, certified, if required by the Commission, by independent public accountants, and also any further financial statements which the Commission may deem necessary or appropriate for the protection of investors. The Commission may also require the filing of such annual reports as the Commission may prescribe, certified, likewise, if required by the Commission, by independent public accountants; also such quarterly reports as the Commission may prescribe and such other reports as the Commission may deem essential in special circumstances. Wide power, and latitude of regulation, are accorded the Commission by the provisions of the Act. In that respect the Exchange Act appears to be more flexible than the Securities Act.

The Exchange Act provides that: "The Commission may prescribe in regard to reports made pursuant to this Act, the form or forms in which the required information shall be set forth, the items or details to be shown in the balance sheet and the earning statement, and the methods to be followed in the preparation of reports, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and non-recurring income, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or desirable, of separate and/or consolidated balance sheets or income accounts of any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer—."

Wisdom of Prescribed Form Questioned

The wisdom or propriety of including such a provision as the foregoing in a law for the regulation of securities exchanges is highly questionable. Governmental bodies tend to become stereotyped and at times arbitrary in their administrative processes. The exercise by the Commission of the powers conferred by this provision might result in retarding instead of furthering the development of accounting practice and the accurate presentation of financial statements.

Thus, for example, there has probably been a greater advance during the past several decades in the accounting practices of representative industrial corporations, audited by professional accountants, than of corporations subject to governmental regulation of their accounting, such as banks and utilities.

One might well question why the rigid provisions of the Securities Act are not made applicable to banks as well as to commercial enterprises. Certainly the history of bank failures during the past decade is not evidence of the superiority of their accounting methods over those followed by industrial concerns. Yet the financial statements of banks are subject to governmental regulation and not, ordinarily, to review by professional accountants. Would a reputable professional accountant dare make an unqualified certification of the finan-

cial statement as published by some banks? A bank may present its financial picture to the public based on book value of its assets. If in a given instance, the accountant were certifying such statement for registration purposes, it might be necessary for him to qualify his certification to show that while, based on book value of assets, the bank appeared solvent, nevertheless based on fair market or realizable value of such assets, it is in fact insolvent. Why should not a depositor who entrusts his money to a bank be entitled to the same information as the investor in the securities of a commercial concern?

In any event, so far as the Exchange Act is concerned, if the Commission is to prescribe methods in the appraisal or valuation of assets and liabilities and in the determination of depreciation and depletion, etc., and the same are sufficiently definite to afford a standard in those respects, the accountant who in good faith applies the same should be conclusively presumed to have fully complied with the requirements of the Act so that his statements should not later be construed as having been false or misleading in any material respect.

The Act further provides that: "Any person who shall personally or through another make any statement in any application, report, or document filed pursuant to this Act or any rule or regulation thereunder, which statement was at the time and in the light of the circumstances under which it was made false or misleading in any material respect, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading." The Act provides that: "The term 'statement' shall be construed to include any omission to state a material fact which is required to be stated in any such application, report, or document, or which is necessary to make the statement not misleading."

Exchange Act Provisions Less Onerous

Note the vital difference between the foregoing provision and that which at present obtains with respect to the same circumstances in the Securities Act. Under the Exchange Act the plaintiff must prove that he relied upon the statement; that he purchased or sold the security at a price which was affected by the statement, and he can recover only for the damages actually caused by such reliance. Furthermore, the court may in its discretion require of the plaintiff an undertaking for the payment of costs of suit and reasonable costs and attorney's fees against the event that he is unsuccessful. That provision at least will have a tendency to discourage strike suits which might obtain today under the provisions of the Securities Act. (The period in which it is possible to bring action under the Exchange Act is limited to six years instead of ten years as under the Securities Act.)

It should be borne in mind, however, that the accountant in certifying under the Exchange Act must maintain the same precautions against misleading statements, or omissions to state facts necessary to make his certification not misleading as under the Securities Act, involving as that does, proper qualifications and exceptions to his certification.

There are also pending before Congress at the time this is written certain amendments, said to have Administration approval, which are proposed to be included as part of the Exchange Act, modifying some of the more onerous provisions of the Securities Act. These proposed amendments are of particular interest and importance to the accountant for if enacted they will affect considerably his liability under the Act.

Section 11 (a) would be amended so that instead of the right to sue extending to "any person *acquiring* such security", it would instead extend to "any person *who, in reliance on such statement or omission,* acquired such security."*

This amendment will probably greatly restrict the number of persons who can hold the accountant liable under the Securities Act. Under section 11 the liability of the accountant extends to any purchaser of the security no matter

* This change was subsequently modified in the amendment, as passed, by a paragraph added to section 11 (a).

how remote from the first purchaser. But under the proposed amendment it is evident that the more remote that ultimate purchaser, the infinitely less likelihood of his having relied on the registration statement.

Standard of Reasonableness Set

Under the provisions of sub-section (c) of section 11 of the present Securities Act, it is provided that in determining what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that of a person occupying a fiduciary relationship. Under the proposed amendment it is provided that the standard of reasonableness shall be that *required* of (I presume this is intended to mean "exercised by") a prudent man in the management of his own property.

Sub-section (e) of section 11 at present provides that the suit of the investor "may be either (1) to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or (2) for damages if the person suing no longer owns the security." Under that section the accountant in case of liability might be held to the amount paid by the investor for the security regardless of whether some of the depreciation in value had resulted from causes other than the misstatement or omission on which the liability of the accountant is predicated. Under the proposed amendment to this sub-section the accountant would no longer be answerable for that part of the damages which he proves did not result from the misstatement or omission forming the basis of his liability.

Another proposed amendment makes provision similar to that of the Exchange Act, permitting the court in its discretion to require an undertaking from the plaintiff for payment of the costs of suit, including reasonable attorney's fees. The advantages of such a provision have already been indicated.

It remains but to add that whether the legal relationship of the accountant to the investor arises out of the common law as defined by the Ultramares case or by reason of the Securities Act, either as now in effect or as proposed to be

amended, or because of the proposed Exchange Act, that relationship in the last analysis is dependent upon the nature of the contents of the accountant's report and certification. The more clearly and completely that such report and certification set forth the matters and things on which the accountant can speak or express an opinion and indicate by qualification and exception the matters outside his sphere or knowledge the less need of his being concerned about the consequences that may obtain in the absence of such kind of report and certification.

Presented at the thirty-seventh annual meeting of The New York State Society of Certified Public Accountants held at the Waldorf-Astoria on May 14, 1934.

Questions Answered by Mr. Sorg

QUESTION: What, if any, liability does the attorney assume under the Securities Act?

ANSWER: Not very much. I presume that has nothing to do, however, with the fact that the majority in both Houses of Congress are lawyers. Doubtless, the Securities Act would have been written exactly as it is, even though that majority in both Houses had been made up of accountants.

QUESTION: Do you not think it is desirable that attorneys representing issuing companies also be included among those liable under the Securities Act?

ANSWER: No, I do not.

QUESTION: The Securities Act defined reasonable care as that of one occupying a fiduciary capacity. The doubt as to how far this went is probably responsible for the statement in certificates that accounts receivable were not confirmed; that certification is based upon reasonable investigation. Do you think this feeling of protection is justified?

ANSWER: The question of reasonable care is a question of fact. Even when it is stated that under the Securities Act the test is that of a fiduciary, it still leaves to the jury the question of what constitutes such reasonable conduct. Now with respect to checking accounts receivable, I understand certain uniform practice obtains among accountants. If fol-

lowed, that would be evidential in determining whether the accountant had acted reasonably. It is not, however, conclusive. In every litigated case the accountant is subject to having the jury pass on the question whether, under the particular circumstances, he acted reasonably in making his check of the book accounts, whether that be by mailing questionnaires to the debtors or otherwise.

QUESTION: How far need an accountant go to avoid omissions which might make his statements misleading? For instance, suppose he knows of past governmental competition which might make a public utilities plant worthless. Need he refer to this in reporting on the public utility under the Securities Act?

ANSWER: That raises a very interesting question. If the accountant has actual knowledge concerning a situation obtained outside his examination of the books, and it could be later proved, (which would not be the easiest thing to do, either) that he had such knowledge and failed to disclose it, that would be evidence for the jury in determining whether or not the accountant acted reasonably under the circumstances. The accountant must make his certification in the light of his knowledge at the time of his examination, regardless of where he gets his information.

QUESTION: Will there be any advantage to companies whose securities are listed, withdrawing from the list and leaving the trading to the over-the-counter market, or the reverse?

ANSWER: It is not likely, because if that were to happen in any large number of instances, the Act would certainly be made to include all those situations, if, as a matter of fact, it did not include them when first enacted.

QUESTION: Will banks whose securities are traded in over-the-counter be required to furnish certified statements? How about those banks whose stocks are listed on the New York Stock Exchange?

ANSWER: In any event, those banks whose stocks are listed on the New York Stock Exchange will come within the provisions of the law regulating the Exchange, and prob-

ably, as well, those banks who deal in the over-the-counter market.

QUESTION: What, in your opinion, constitutes personal knowledge within the meaning of the Securities Act?

ANSWER: Of course, the Act does not use the word "personal knowledge." The knowledge of the accountant is gained not only from that which he knows personally, but from that of his employees, and from that of those people representing the company with whom he comes in contact. The test is whether he acted reasonably and whether he used all reasonable effort to make his examination and certification present the true picture of the corporation at the time of his examination.

QUESTION: In the event that a stock has depreciated in value, but not to the extent of the security of a similar corporation, will a loss have been sustained?

ANSWER: In my opinion, yes. The test is not whether a similar corporation stock is selling at a higher or lower price, because that might be affected by any number of circumstances. The question would be whether or not the particular stock is selling at a price less than that at which it was offered to the public.

QUESTION: To what extent, if any, do the regulations of the Federal Trade Commission, affect the liability of the accountants?

ANSWER: The answer is that a regulation of the Commission, in so far as it is within the purview of the Act itself, is just as binding and effective as though part of the Act.

QUESTION: If a judgment is obtained against an accountant, would it comprise a fraud or civil judgment? Is such judgment a dischargeable debt in bankruptcy?

ANSWER: Under the Act, the accountant is liable for his negligence, regardless of whether it constitutes fraud. The judgment would be a civil judgment, and could be discharged by bankruptcy in the absence of wilful fraud on the part of the accountant.

QUESTION: Is a test of what is misleading the viewpoint of one understanding financial statements or the viewpoint of one ignorant of the proper interpretation of financial statements?

ANSWER: That is a very good question. The answer is this: It is neither the viewpoint of the expert nor the viewpoint of the ignoramus. It is the viewpoint of the average reasonable person who would understand the average financial report as presented. It would mean, for example, that some person who could not understand any report whatsoever, could not claim he had been misled. On the other hand he would not have to show that he had all the knowledge of the accountant in order to properly understand it. The test of what constitutes the average reasonable man is difficult to define, because in the last analysis the jury answers that question and one never knows with certainty how it arrives at the result. Someone once said that there are two things in this world which no one could foretell. One is whether the next child is going to be a boy or a girl, and the other, what a jury is going to do under any given circumstances.

QUESTION: If a corporation wishing to float an issue has already submitted a financial report within the regulations of the new Exchange Act, would another report be required under the Securities Act?

ANSWER: The Exchange Act expressly provides that none of the provisions therein shall relieve the issuer from furnishing whatever information may be required under any other Act.

QUESTION: Regarding accounts receivable in the light of your remarks, how does the accountant appear liable when his engagement is such that he is told, "Don't send out any notices confirming the receivables, don't age the accounts over thirty, sixty or ninety day periods," and third, "I don't want my customers to know of the order"?

ANSWER: I presume the answer is that that would be one of the engagements you had best leave some other accountant to take.

QUESTION: Must an accountant disclose information affecting an issuing corporation which the accountant has obtained from his engagement with a second client?

ANSWER: I think I have already covered that. If the accountant, at the time of his audit and certification, has information, the omission of which would make his statement or certification misleading, he is liable under the Act, and it makes no difference where he obtained his information. The better part, of course, in that case, would be to inform the client of the fact that he had that information and leave it to the client to engage someone else who didn't possess it.

QUESTION: From the giving of a certificate which is so full of qualifications that it becomes predominantly negative in character, couldn't the client feel that the certificate is of no value, but rather a hindrance, in giving any assurance of the substantial truthfulness or dependability of the statements to which it is appended? Wouldn't the investigator get the impression that the number of qualifications indicates a situation to be avoided, even though most or all of the qualifications do not question the substantial correctness of the figures in the balance sheet or income account, but in effect point out, with respect to various items, that he is not an appraiser or a lawyer? Must not, in the final analysis, weight be given to accepted accounting principles and practical limitations on the accountant's examination, which are recognized in the business and financial world, without, in effect, reciting them in such certificate? Would not the practice of the trade be given due weight by a court in considering the accountant's duty, and the reasonable import or implications of a certificate?

ANSWER: So far as final determination of the fact is concerned, it rests with the jury. A judge might charge the jury that it has the right to consider, among other things, the custom obtaining in the trade or profession in determining what constitutes reasonable conduct of the accountant, but the difficulty is that there is no assurance that the jury will do that. If the question is left open to the jury, and it must be, to determine whether the accountant acted reasonably or not, the only safe course for the accountant is to have his

qualifications and exemptions in such form that there cannot be room for interpreting negligence on his part. Moreover, it is possible in some courts to have the juries answer specific questions. For example: In what respect was the accountant's statement misleading to the investor? The question whether or not the record discloses evidence justifying the answer given by the jury can then be considered by the court of appeal. The only safe course for the accountant is to qualify his statements so as to confine his certification to what he knows, and not pretend knowledge of matters concerning which he has no knowledge, for as Justice Cardozo stated, the pretense of knowledge in the absence of knowledge, is ground for an inference of fraud.

QUESTION: Is it necessary that the same qualifications be included in a certification not made for registration purposes, as are included in one which is made for registration purposes?

ANSWER: Now that is a very good question and it also raises a very interesting problem. Suppose, for example, the accountant had certified a statement not for registration purposes and that statement had been distributed by the client, and suppose later the accountant was asked to certify that same statement for registration purposes, and then modified and qualified it. The very fact that he had given two different certifications under those two different circumstances might indicate, so far as anyone relying on the first statement was concerned, that he had been guilty of fraud. Consequently, in any event where there is a possibility of a statement later being used for registration purposes, the accountant should qualify his certification as though it were now being used for registration purposes. Moreover, even though in a particular case the accountant knows the certification is never going to be used for registration purposes, and hence would not come under the Act itself, he still should be on his guard, for, if later, action were brought on that particular statement under the common law principles of the Ultramares case, it might well be within the province of the plaintiff's attorney to inquire why the certification in that instance was so brief, as compared with a whole series of

qualified statements which that particular firm had been making in other statements for registration purposes. The inference of fraud might more easily be found in that situation than if they were all uniform.

QUESTION: An accountant certifies to the statements and supporting schedules in a registration statement, the statements and schedules containing full explanations and qualifications. Is it necessary for the accountant to repeat the explanations and qualifications in a certificate?

ANSWER: The wording of the exceptions and qualifications in the certification should be made broad enough to include not merely the matter specifically referred to in the certificate itself, but also those contained in the supporting or appended schedules.

QUESTION: Can you think of any good reason why accountants should not incorporate, in view of the unreasonable liability that might be saddled upon them under the Securities Act?

ANSWER: Of course, in that respect, they are in the same position as attorneys. Attorneys do not incorporate either, but generally they take care that whenever they give an opinion, there is not much room for liability.

QUESTION: How sure can we be that qualifications in a certificate really limit the liability imposed on the accountant?

ANSWER: I presume that goes back to the opening statement in my address, that the legal and accounting professions these days are closely akin. If the accountant is not certain, it will be far more economical to obtain legal advice before making the certification, instead of after suit is brought thereon!

QUESTION: In all probability, banks will require audits by certified public accountants, since they must pay toward the Federal or state examinations. Is there any arrangement where they could save the cost of one or the other?

ANSWER: My thought would be that if the banks once come within the provisions of the Exchange Act, it will be necessary for them to have their accounts certified by independent accountants, just the same as any other corporation which has its stock listed.

Investment Banking Phases of the Federal Securities Act and the Securities Exchange Act

By Hugh Knowlton, Partner
of KUHN, LOEB & CO.

I AM most appreciative of the opportunity of addressing you tonight, first because of the eminent standing of your Society in the profession of accountancy, and secondly because of the nature and quality of the profession itself. In these days of changing winds and shifting sands it is comforting to be aware of that great body of certified public accountants throughout the country who stand for certain fundamental principles which do not change. Yours is that rare thing, a profession which is at the same time almost an exact science. It is upon facts, expressed in the crisp, cool medium of figures, that your professional opinions are based. The knowledge that the brotherhood of certified public accountants is the guardian of a field in which the art of experimentation is definitely circumscribed is, to say the least, reassuring. For no one can with impunity experiment with balance sheets or income statements, so long as he has to run the gamut of your vigilant and penetrating eye.

The subjects on which I have been asked to speak are The Securities Act of 1933, and the pending legislation to be entitled The National Securities Exchange Act of 1934. You have heard this afternoon that statute and that bill so ably discussed from three technical standpoints — namely, the legal, the accounting, and that of the corporate executive — that anything which I might add from a purely technical standpoint would be in the nature of gilding the lily. My approach to the subject will be that of a banker, whose profession, needless to say, is vitally affected by this legislation. And while I welcome the opportunity to put before you certain phases of these laws, actual and proposed, which have to do with banking, I am going to ask your indulgence in permitting me to go beyond this particular aspect. For I

feel that the problems presented transcend in importance the interests of any one profession or class and strike deep into the vitals of our national economy.

The Securities Act of 1933 and the proposed National Securities Exchange Act of 1934, otherwise known as the Stock Exchange Bill, have in common the purpose of reforming the securities business and protecting the purchaser of securities. No decent citizen can quarrel with this underlying objective. No decent person can fail to be enthusiastic for its achievement. The industrialist, the lawyer, the accountant and the banker — all of whom contribute in their respective ways toward the creation and sale of securities — these must be in accord with the objective no less than the countless men and women who make up the great body of direct or indirect purchasers of securities in this country.

The Securities Act, passed about a year ago, has as its major theme the requirement of disclosure. This is borne out by its nick-name, "The Truth-in-Securities Act." The subject matter of this statute is confined for the most part to new issues of securities.

The Stock Exchange Bill has, as I interpret it, three major motives: The curbing of speculation, the prevention of manipulation and other harmful practices in the securities markets, and the continuing disclosure of adequate information in respect to securities generally, whether representing old or new issues.

Rigidity and Flexibility in Regulation

To me one of the most interesting points in connection with these two pieces of legislation is the wide difference in their manner of approach to their respective problems. The Securities Act represents an attempt to regulate by particularity. It is rigid. It spells out by chapter and verse what must be done to qualify a new issue. To an audience of experts such as this I do not need to do more than refer to schedules A and B in corroboration of this statement. The detailed information required under schedule A to be filed in connection with new issues in order to qualify them for registration is so burdensome as to be utterly impracticable in the case of corporations of magnitude. And in addition,

except in the cases of relatively small or new corporate enterprises, the requirements of schedule A defeat their own purpose by the very weight and detail of the data for which they call.

There are many, many corporate enterprises in this country which by virtue of their size, records and standing afford the basis for the highest type of security, but for them as issuers to attempt to meet the requirements of schedule A would necessitate the preparation and publication of literally volumes of technical data of no possible use to the average investor; indeed much of which he could not understand.

Under the Act, although the Federal Trade Commission is authorized to add to the registration requirements categorically set forth, its power to reduce them is extremely limited, even though in its best judgment in the light of experience it should desire to do so.

The same thing is true of other requirements of the Act, both substantive and procedural.

In extreme contrast to this is the proposed Stock Exchange Bill, which proceeds on the opposite theory, namely, that the commission created to administer it should have the fullest discretion and power both to waive requirements and to increase them. This is particularly true of the Senate bill, which, unlike the House bill, does not even undertake to lay down any fixed margin requirements.

Here we have two radically different approaches. One a statute of rigidity, the other of flexibility.

The shortcomings of a statute of rigidity are obvious and have proved themselves already. The shortcomings of a bill of the flexible type, such as the Stock Exchange Bill, are equally obvious, for the operation of such a bill carries with it a continuing lack of definiteness and creates continuing uncertainty in the minds of those operating under it.

Of the two types I greatly prefer the latter because to my mind it is better for any legislation covering a field so complex and so technical to have a flexibility and an adaptability to change in the light of experience, without resort to Congress, than to be rigid and immutable until such time as an amending act can be obtained.

Considers Neither Form Perfect

To my mind, however, neither bill embodies the most effective and beneficial technique of approach. In the case of a rigid statute, such as the Securities Act, the country is stuck with its defects until such time as Congress can pry it loose. In the case of a flexible bill giving broad powers and latitude to a commission such as that proposed by the Stock Exchange Bill, we have a fostering of bureaucracy and the creation of a bureaucratic control of unprecedented magnitude.

One may then ask me: "What do you want? You have said that you are in sympathy with the motives behind these two bits of legislation. You have pointed out that they are extremely different in their type and manner of approach, and then you end by saying that you don't like either of them." A very fair question and one which I will answer as follows:

In my opinion the legislation of ethics can only go just so far in "filling the bill," and that legislation which is the most effective is that which is simplest and which confines itself to the expression of a relatively few clear, understandable principles, the interpretation and enforcement of which is left to the courts. Such legislation is typified by the British Companies Act, which deals with the same subject matter but with far greater simplicity, fairness, certainty, and therefore effectiveness, and without regulations and bureaucracy.

Any reform legislation, however, must be buttressed by two things:

1. Public opinion, and

2. Discipline and control within the profession or industry itself.

It is clear that public opinion is keenly behind reform of the securities business, so I do not think we have to worry much on that score. The second buttress is already in effect, though little known by the public at large.

I refer to the code of fair competition for investment bankers which recently went into effect under the N. R. A. This code is the result of months of unremitting labor on

the part of selected investment bankers, in consultation with more than a thousand trained and experienced minds whose organizations comprise the leading investment houses of the country. A knowledge of this code and its scope, and I am referring particularly to that part of it known as its fair practice provisions, will, I think, open the eyes of many to two things:

1. The comprehensive and conscientious way in which the profession itself has set about to improve its standards and its practices, and

2. The vastly greater field of subject matter which such a code can effectively cover than is remotely susceptible of being covered categorically by statute. In this last year, the investment banking profession has created, quietly and without the fanfare of trumpets, a code which far transcends in its scope that of the legislation under discussion.

Praises Investment Bankers' Code

For example, it deals at length with what to my mind has been one of the greatest evils in the securities business in the past, namely high pressure salesmanship. I do not believe that the manner of making sales in a business as broad and complex as the securities business can ever be properly or effectively controlled by statute. It can, however, be controlled within the profession itself, with the help of public sentiment.

The same is true of another harmful feature of the securities business so prevalent in the boom days which the code undertakes to correct. I refer to the reckless competition for new issues by American originating houses, resulting in a mad scramble for business with far too little regard for the quality of the security offered.

Also the code is replete with provisions designed to establish a continuing recognition of the duties of the investment banker and the securities dealer to their customers. I will not weary you tonight with an enumeration of the many matters upon which it touches, but I commend these rules of fair practice to your study, particularly as they deal at length with accounting practices. We all know that one of

the most pernicious features of corporate financing in the past has arisen from the intricacies of the holding company set-up, giving rise to confusing inter-company transactions and relationships. With the help of your profession, the investment banker has incorporated, in his rules of fair practice, provisions designed to lift the veil from the complicated corporate picture. I submit that your profession and ours, working continuously together through our respective organizations, can do more to accomplish the desired result, to the benefit of the American investor, than can a governmental commission wielding the big stick from without.

The complexities of the securities business are many. I do not believe that experimenters, motivated as they may be by the loftiest purposes, can, without technical knowledge and experience, accomplish reform either as complete or as effective as that which can be accomplished by the members of a profession itself. Neither do I believe that a governmental bureaucracy such as is contemplated by the Stock Exchange Bill can serve as well — certainly not without the danger of political influence and the fear of over-regulation.

You may ask what assurance there is that such reforms, instigated and administered from within, will be carried out. The answer is that the code itself provides for disciplinary measures which I have no doubt will be as effective, if not more so, than the threat of fine or imprisonment. For example, it provides for the qualification by registration of investment houses, and for penalties, including suspension from the ranks, for infraction of the rules. I am sure that your Society can testify to the effectiveness of such disciplinary action.

Studies Results of Securities Act

Now as to the actual results of the Securities Act, which became effective on July 27th of last year. The yearly average of offerings to the public of the securities of domestic corporations, from the beginning of 1919 to the beginning of 1932, was $4,360,000,000. In this period there were good years and bad. It included the depression of 1921 and 1922, the recovery period thereafter leading up to the boom, and the years immediately following the crash. In the first seven

months of 1933, a period which included the bank moratorium and the dark days preceding it, the amount of such public offerings was $313,266,000. A staggeringly small figure in relation to normal, but as the effects of the renewed confidence of the late spring became felt, one would have supposed that in the natural course of events the amount of new financing would have shown a marked increase. What actually happened? In the last five months of 1933 the figure fell off to $66,584,000.

Thus it will be seen that the business of financing corporate enterprise in this country through the investment market fell almost to the vanishing point after the enactment of the Securities Act. The figure for the first quarter of 1934 is no more reassuring, amounting to only $49,000,000.

Three arguments, which I contend are three fallacies, have been advanced as the reason for this decline.

First, — that this cessation of activity represents a conspiracy on the part of bankers to force a change in the law. To my mind nothing could be sillier. Even bankers must live, and in order to live must do business. Speaking for myself and my firm, I can assure you that nothing would delight us more than to be able to do a normal amount of issuing business and that we would do it tomorrow if we could honestly advise our corporate clients that they could bring out new capital issues without unreasonable, uncertain and unjust liabilities to themselves, out of all proportion to the benefits to be derived, and if the legal opinion of the country did not advise us that we in turn could not prudently assume the risks involved. In this connection it may be interesting to note that although the volume of recorded business done by investment bankers in this country decreased over 90 per cent in the past four years, the number of their employees has decreased but 38 per cent, and the wages of their employees have decreased on an average of only 15 per cent. This would appear to me to indicate that the investment bankers as a class have maintained the burden of high overheads, not for the pleasure of starving themselves, but in the hope that they can soon resume active business.

The second fallacy current in many quarters is that the

investment bankers and the corporations will crawl out from hiding and bring out new issues as soon as the market is ready. In other words that the paucity of new financing is due, not to the Securities Act, but to market conditions. That this is not the case is borne out by the impressively high prices at which the outstanding issues of high-grade bonds are selling today. There are countless individuals in this country who have idle funds, awaiting investment in sound securities. Similarly with the banks, the savings institutions and the insurance companies, whose funds are piling up daily. It is the business of the investment banker to know whether and when the market is there, and I know that today the market is present for good investments.

This leads me to the third fallacy: That there is no real industrial demand for capital financing and that we are now going through a natural corrective process directly attributable to over-building, the creation during the boom period of excess plant facilities, and over-purchasing. Quite apart from the needs for refunding maturing outstanding long term obligations and funding outstanding bank loans which have been granted for capital purposes — and I have recently seen an authoritative and specific list of such funding and refunding requirements which should be met at this time and which total $1,200,000,000 — quite apart from these needs I know also of cases where important financing should be provided at this time for capital improvements, and also in connection with reorganizations whose prompt consummation is vital to the interests of large groups of capital and labor. It is the business of the investment banker to know and properly appraise the financial needs of his clients, and again I say, from my own knowledge, that there is much sound capital financing which should be done now. And finally, in refutation of this fallacy, one has to look no further than Washington, where there are at this time under consideration several measures for the placing of government funds at the disposal of industry in the form of capital loans of up to five years' maturity. The long list of present applicants for such loans in Washington bears ample testimony to the pressing need of industry in this connection.

Capital Financing by Commercial Banks Wrong

There is constant pressure on the commercial banks to supply this financing, and in many instances the commercial banks have done so. There is grave danger in this, as we all know, both from the standpoint of the commercial bank, whose loans should be current and self-liquidating, and from the standpoint of the borrower, who should not put himself in the precarious position of financing his long term requirements by means of short term loans.

We have seen, in spite of an investment demand, in spite of industry's sound and legitimate need of financing, and in spite of the availability of the investment banker to do his share in bringing the two together, that the quantity of new corporate financing through the private investment market has nevertheless fallen off to an alarming extent since the enactment of the Securities Act. The impressiveness of this decline is borne out by the contrasting experience of the London market, the volume of whose corporate issues in 1933 was off only 22 per cent from the volume in the active year of 1928. The comparable decline of corporate financing in our market was 94½ per cent!

It is equally significant that the quality of our new financing, from the investment standpoint, has likewise suffered. Two-thirds of the new corporate financing in this country last year took the form of common stock issues, the bulk of which was for the liquor and allied industries, with a large part of the remainder in the stocks of new ventures such as gold mines and other speculative enterprises.

In the past in this country a strong investment market, coupled with the flow of new funds into seasoned enterprises, has been a necessary concomitant to business recovery. Such operations, under the Securities Act, have been conspicuous by their absence.

This leads me to what I regard as the most important part of what I have to say, and that is the real significance of this stagnation in the capital markets and the inability of industry to obtain its capital requirements in the normal way.

Upon whom has the burden of this suspended animation

been falling? The answer is simple. It has been falling upon our government. According to the President's last budget message and subsequent legislation, the government and instrumentalities guaranteed by it will, from the date of the organization of the R. F. C. on February 2, 1932 to June 30, 1935, have made extraordinary expenditures to the prodigious amount of $16,837,000,000. By extraordinary expenditures I mean those falling outside the cost of running the government machine.

Let us analyze these extraordinary expenditures of nearly $17,000,000,000. Between six and seven billions represent amounts spent for purposes upon which private investment capital would not normally embark, such as relief of distress and unemployment, conservation and improvement of government-owned natural resources, and public works. For the sake of clarity, I will call these type A expenditures.

Government Replacing Investment Banker

The balance of ten and one quarter billion will have been spent, not for purely governmental purposes upon which private capital would not normally embark, but for purposes coming within the field of private capital. I refer to loans to banks, railroads, mortgage companies, farmers, home owners, loans by the P. W. A. for private undertakings, loans for power development, etc. I will now divide this vast category into two classes: Loans not good enough for private capital, but which the government is making as a rescue party. I will call these type B expenditures. And lastly, loans made by the government which private capital would, except for some extraneous reason, be glad to make. These I will call type C.

The type A expenditures are clearly attributable to the emergency. They are expenditures necessary to bring relief to a stricken land. No one can quarrel with them. Rather one must admire the energy with which they were initiated and are being continued.

Similarly with type B, which while for purposes outside of the normal field of governmental expenditures, were made to meet an emergency situation.

Type C, however, tells a different story, for there the

government is directly invading the private investment market.

There are no data showing how much of the figure of over $10,000,000,000 comprising type B and type C falls into each category, respectively, but it is certain that the amount of both types is enormous.

If by the end of the next government fiscal year, namely, June 30, 1935, the indicated extraordinary expenditures have materialized, we will have increased our government debt, including obligations unconditionally guaranteed by the government, to nearly $36,000,000,000, which is 9½ billion greater than the war-time high and is over 220 per cent of the amount of our debt in the middle of 1930.

That the service of this increase in debt will involve great deficits is undoubted. The eventual deficit is, however, undeterminable for it will be mitigated to the extent that the loans in type B and type C are repaid.

Therefore, from the point of view of our government finances, the better the quality of the loans being made by the government, the better the chance of finally achieving a balanced budget.

Warns of Further Inflation

Now I do not need to tell this audience how essential it is that our national budget be balanced as soon as possible. I do not need to tell you that increasing deficits mean increasing tax burdens and a drag on business, and that if they are not finally curbed, an impaired national credit is bound to result. I do not need to tell you that sound money is impossible in the face of continuous and increasing budgetary deficits.

The President has expressed the hope that by June 30 of next year conditions will be such that the trend of government deficits can be reversed and that from that time on our government may have a balanced budget. Well may he hope so and well may we all join in prayer to that end. For if that end is not to be achieved — if not at that exact time at least not long thereafter — further inflation will be upon us.

Therefore, why may it not be argued that the more of the

government's loans to business which are of sound investment calibre — and, therefore, do not represent a drain on the national exchequer — the better? From the standpoint of the government credit, yes. But the course of government as an investor in business, in competition with the private investment market, is an evil by itself which goes to the very fundamentals of our economic and political life.

I have always believed that the political philosophy which has prevailed in our country since its founding is that business and government are separate and distinct; that the purpose of government is to govern and that industrious enterprise for profit is the prerogative of the individuals making up the body politic.

I maintain that if government goes into business for the sake of making money, it is not minding its own business. And it is assuming risks (for there is hazard in all business and some losses are inevitable) that do not properly — under our traditional conception—come within government's proper province.

It is true that government can lend money to industry at a cheaper rate of interest and on terms otherwise more favorable than the credit of a particular borrower, as reflected by the barometer of the investment market, would warrant. But is it to the eventual benefit of industry that it receive financing on terms more favorable than its credit justifies? I think not. For the most effective brake upon unwise expansion is then removed.

Facing Government Ownership of Industry

Do the American people wish to have their government assume that proprietary control over industry which such a creditor position carries with it? I think not.

Do the American people feel that government control would cause industry to be more successfully operated? I think not. Look at the record of government controlled transportation in this country during and after the War, which resulted in a net loss to the government of $1,100,000,000 in a period conspicuous for its heavy traffic.

If there are those who would like to see government in

business as a matter of principle, and I suspect that there are, let them come out in the open and say so.

In June of last year Baron Edouard de Rothschild, chairman of the board of directors of the Chemins de Fer du Nord, stated in the course of an address to the stockholders of that railway:

> "The State has become the infallible protector, the dispensator of all benefactions and of all favors. The principles of State Socialism have been able to expose themselves with all the more impunity in that they found the thread of Ariadne enabling them to find their way insidiously and without hindrance through all the domains of the national economy under the designation of 'A managed economic system.' And this is the scourge that is ravaging every country and will continue its evil effects on all sides until it has been proved a failure. It is carrying us on straight to the socialization of all the productive forces of our country."

These words were spoken in one of the most capitalistic countries in the world. Had the Baron at that time been speaking in our country rather than in his native France he would have received polite attention and possibly agreement from a limited audience, but no more. For we were then in the first flush of a recovery which had been initiated with a magnificent courage and supported with an eager enthusiasm throughout our country.

But since then we have heard much of regimentation, managed economy, and the like. We have heard quite recently many of the advocates of the new deal protest when it has been intimated that the results of the present course of government were perhaps as revolutionary as evolutionary. Be that as it may, one thing is true and that is that public funds cannot indefinitely replace private capital in business without causing an evolution of our entire economic system which will in fact be revolution.

Private Capital Financing Called Remedy

I do not think that I am crying "Wolf" when I say this. I point again to government's pending investment of over ten billion dollars in business. This is a tidy sum, and one which must give pause even to a country of our size and

wealth. But he who sounds a warning without suggesting a remedy is performing a very incomplete service.

My remedy is for government at the earliest moment to make it possible for the private investors of the United States to assume their rightful place as the suppliers of the capital funds needed by the industry of the United States. In doing so the government will not be making any sacrificial offering, inconsistent with its own interests. On the contrary, it will be lightening the yoke around its own neck. For the liberation of the normal channels of capital financing will provide an impetus to business which should immediately relieve the government of the necessity for making any more type C loans. This will cause a natural business revival which will turn many of the government's type B loans into type C loans, which can and will in due course be taken off the government's hands by the investment market. In support of this contention I cite an historical precedent. After our last great emergency, the World War, our government had to lend vast sums to our railroads to help them weather the storm. As conditions became normal the task of financing the railroads by private capital through the usual channels was quickly resumed, with the result that over 96 per cent of the government loans were repaid or resold in the investment market.

And further, such a course would have the inevitable result of lessening the government's type A activities through lessening the requirements for relief. In short, such a course would speed the end of the emergency.

All this can be accomplished simply by an adequate amendment of the Securities Act and a tempering of the Stock Exchange Bill — in other words by a removal of the actual and threatened legislative impediments.

I realize that in pleading this course I can be accused of pleading the cause of self-interest, but the problem is not one of the well-being of any single business or profession. It is a problem which is of the utmost concern to every laboring man in the country, to every white collar worker, to every farmer, to every proprietor.

Our government is doing everything in its power to en-

able commercial banks to fortify themselves so as to be in a position to grant current loans to industry, as witnessed by the fact that up to the 5th of April of this year the R. F. C. had invested over a billion dollars in the preferred stock and notes of nearly 6,500 commercial banks.

Encouragement of Private Lending Needed

I maintain that the government must also encourage the normal instrumentalities of long-term financing to function again.

Investment bankers do not ask for financial assistance from the R. F. C. or from any other governmental agency. All they ask is a chance to perform their true and proper service to industry and to the community. They recognize that the conduct of their business, and of what business can this not be said, has in the past been far from perfect but they are indignant at the incendiary publicity emanating from Washington at a time when what is needed is a co-operative effort for recovery along improved lines of endeavor. One would suppose from the bitterness which has been so prevalent in recent months that the investment bankers, and I use that term to mean those of the profession who have had high standards in the past and will continue to have them in the future, had sold to the public nothing but lemons. It would perhaps help people to realize the injustice of this assumption if they took note of the present prices of all bonds listed on the New York Stock Exchange (including foreign bonds but excluding U. S. Government obligations). The average price of such bonds on April 1st of this year showed a decline of only 14 per cent from the average price of such bonds on September 1, 1929, at the height of the boom. How many individuals whose money has been in real estate during this period, or in one of the hundreds of thousands of small businesses (which have failed in this country at the rate of over 20,000 a year), have fared any better, if as well?

It is true that the prices of stocks still show a severe decline. It is true also that in the issuance and sale of stocks there have at times been grave abuses which can and should be eliminated. But there is inherent in every purchase of

stocks a speculative element — just as there is in the purchase of commodities — and nothing that Congress can do will ever make it otherwise.

The investment banking profession stands ready to perform its invaluable task of raising from the private investment market of this country the funds that industry must have to carry on. Some weeks ago our very able Secretary of Agriculture, Mr. Wallace, wrote an article on another subject entitled "America Must Choose." The burden of my remarks tonight might well be entitled "The Government Must Choose."

What is the choice? It rests between two roads. One leads to the continuing participation of government in business, resulting in either an intolerable burden on government credit with financial consequences beside which our recent experiences will pale into insignificance, or a usurpation by government of the reins of business against which the American people will eventually protest in no uncertain terms. The other road leads to recovery along the natural route through the resumed flow of private investment capital into business. The choice rests in Washington — not at some later day — but now.

Presented at the thirty-seventh annual meeting of The New York State Society of Certified Public Accountants held at the Waldorf-Astoria on May 14, 1934.

Questions Answered by Mr. Knowlton

QUESTION: Isn't it a fact that with the repeal of prohibition and the subsequent commencement of the liquor industry, financing was not deterred by the Securities Act in this new industry?

ANSWER: There has been a good deal of liquor financing since the Securities Act became effective, but I believe that much sound financing in this industry has been deterred by this statute. I happen to know of one definite case in point, that of one of the oldest and best liquor companies in the country, which would have done public financing quite some time ago except for the Securities Act.

QUESTION: Do you think that there has been any substantial shrinkage in new issues attributable to the check on wild-cat financing through the enactment of the Securities Act? If so, what would be your estimate?

ANSWER: It is absolutely impossible for me to make an estimate. I suppose there must have been a check on wildcat financing, just as there has been a check on seasoned investment financing, but it is true, I think, that a law like the Securities Act very often does not work out to be as much of a check on the very type of thing that it is intended to control, namely, wild-cat financing, as it is on the better type. The reason for this is that wild-cat financing is sponsored by irresponsible houses which have very little to lose, either in reputation or money, by bringing out inferior issues and by subjecting themselves to the liabilities of the Securities Act.

QUESTION: Are the proposed changes in the Securities Act sufficient to enable the banking fraternity to function normally?

ANSWER: I will answer that question as best I can, although I don't know that it can be satisfactorily answered yet, because the proposed amendments to the Act have not been out long enough for people to have had an opportunity thoroughly to evaluate them. But I would say that they go a long way in improving certain parts of the Act. For example, I believe that the civil liability provisions of section 11 are made fairer by the proposed amendments, although my initial impression is that even here the changes do not go as far as they properly should.

Also, the amendments, if passed, would serve a very useful purpose in shortening the time in which suits can be brought, and in deterring blackmail and strike suits by requiring that the losing, unmeritorious litigant must pay costs, and that the court may, in its discretion, make the plaintiff put up a bond. There are various other helpful provisions in the amendments. However, they are defective in at least one important respect, which I stressed particularly in my talk, in that they do not relax the requirements for data under schedule "A." As bearing on the impracticability of

these requirements, I heard the other day — I can't vouch for it, but I would be surprised if it were very far wrong — that if one of the largest companies in the country had to qualify under the Securities Act and had to register under schedule "A," the material necessary for such registration would require two freight cars to carry it to Washington. I don't think that the amendments, as yet proposed, are doing anything to alleviate that, to my mind, very important factor.

QUESTION: Is it not a fact that because of the depression and over-abundance of factory and production equipment, new financing is not as necessary as heretofore, so that the falling off of financing is due to these causes, and not to the Securities Act.

ANSWER: I thought I had answered that in what I called, in my address, "the third fallacy." There was certainly an amount of overbuilding prior to the depression, and it is, of course, true that the capital needs of industry decline with the decline in the level of business activity. But time brings about obsolescence and creates a gap which has to be filled, and I firmly believe that there is a great deal of capital financing, apart from very obvious refunding needs, which ought to be done today.

QUESTION: Do you believe that mere disciplinary action by an investment bankers' association, such as expulsion or suspension, could instill in the hearts of fly-by-night underwriters the same respect for honesty that would the very definite penalties which the law can impose?

ANSWER: No, but I do think that the very existence of fly-by-night underwriters will be eliminated more effectively by disciplinary action in the profession itself than by statute.

QUESTION: Please compare points of English and United States legislation.

ANSWER: I am glad to do that, because I think one of the most exasperating contentions has been that our Securities Act is like the English Companies Act. That is a misapprehension, genuine or not, which is persisting even to the present time, in spite of the fact that a great deal has been written on the subject which has pointed out the dissimilarity

between the two statutes. In answer to your question I am going to quote from the report of the special committee of the American Bar Association on Amendments to the Securities Act of 1933:—

"There are many notable points wherein the English Act is less severe than the Securities Act. For example, the English Act provides that:

1. Civil liability is imposed only for an untrue statement. By court decisions this has been construed to include partial statements and certain omissions.
2. Damages are limited to those arising from the untrue statement.
3. Reliance on the prospectus (which serves for both registration statement and prospectus under the English Act) must be proved by the purchaser.
4. Directors are not liable if they have reasonable ground to believe that the statements are true. There is no requirement for a 'reasonable investigation' and the standard of reasonableness is not that of a fiduciary.
5. Underwriters are liable in the same way as directors, but, in substance, only if the prospectus is published over their names.
6. Experts are not liable.
7. Actions are for damages only, not for rescission (except at common law).
8. There is no separate registration statement. Copies of the prospectus must be filed, and must contain certain information. The information required is in some respects similar to that required by schedule A and the present regulations of the Commission, but much simpler.
9. There is no 20-day or similar period which must elapse between the time of filing the prospectus and the offering.
10. The entire theory of administration is different. The English Act contains relatively simple provisions using business terms in their customary sense, and its interpretation is left to the courts. The Board of Trade has no powers in connection with these matters similar to those given to the Federal Trade Commission; there are no regulations, there is no bureaucracy.

It is obvious that the statement that the Acts are similar is at best only true in the most superficial way and is definitely misleading."

QUESTION: You say that bonds have declined approximately fourteen per cent since the 1929 peak. Why this moderate decline in the face of our devaluation of currency?

ANSWER: I think to understand this one must appreciate the fact that the internal or domestic purchasing power of the dollar has not decreased as much as the value of the dollar has decreased in terms of gold, and that the market value of fixed income obligations is affected more by this purchasing power than by the dollar's gold value.

QUESTION: Why is a Stock Exchange Regulation Commission any worse than a commission like the I. C. C.?

ANSWER: I think that the answer is that the commission proposed to be set up by the pending legislation has far greater powers than the I. C. C. has, and its scope is much broader.

QUESTION: What happened to business when left alone?

ANSWER: Well, I think that the person who asks that knows just as well as I do, but I would like to take this opportunity of saying that I don't think that what happened to business when left alone was due nearly so much to Wall Street and the "wicked bankers" as it was to the speculative spirit prevailing throughout the country during the boom and the desire on the part of most people to get rich quick. Now there is no question about it, that it is a good thing to prevent a recurrence of the excesses of the past. I think, though, that there is real ground for difference of opinion as to the proper and most effective way to do it.

QUESTION: Why is big business so anxious to get rid of government, now that government has shown the way out?

ANSWER: I don't think that government has yet shown the way out.

QUESTION: How would you put over 9,000,000 men to work at once?

ANSWER: Well, of course, I think that is rather a foolish question. I will say, though, that the only way to increase employment on anything like a permanent basis is to encourage business to make money. In other words, I don't think you can soundly solve the unemployment problem if,

at the same time, you lessen the opportunities of business to prosper in a reasonable way. I refer you, in that connection, to James P. Warburg's book, called "The Money Muddle," in which he touches on that broader subject, and he emphasizes as effectively as I have ever seen it emphasized, that the true basis of recovery must be the resumption of profitable business. I also cite the example of England and the nature of the recovery which she is experiencing.

QUESTION: If the government had not stepped in and lent ten billion to industry, will you deny that the great majority of them would now be in bankruptcy, since they could not receive assistance from the banking interests of the country during 1931, '32 and '33?

ANSWER: I want to make it perfectly clear that I am not criticizing what the government did in the way of stepping in where the investment mechanism had temporarily broken down. I think that in doing so, the government did a necessary, admirable and praiseworthy job. All I attempted to say in my address was that where government goes beyond that, and by restrictive legislation makes it difficult or impossible for the natural channels to operate again, it is there doing something which is a very different story.

QUESTION: Will not a balancing of the budget at this time cause resumption of the deflationary influences existing prior to March, 1933?

ANSWER: I am confident that an early balancing of the budget would not have the deflationary effect that is feared by the person who asked this question. On the contrary I can think of nothing that would contribute more to lasting confidence. My fear is quite the opposite, namely, that the budget will not be balanced soon enough.

QUESTION: Outside of bonds, are not most investors in common stocks involuntary investors who are misled by market activity and new issues?

ANSWER: No, I don't think so at all. I think most purchasers of common stocks buy them quite voluntarily and because they think or hope the stocks will go up. There have been improper market activities which should be corrected, and which are in the process of being corrected, but I don't

think they were or are the cause of most of the purchases of stocks throughout the country.

QUESTION: Would a limitation of the ratio between the long-term debt and the capital of a corporation, say 1-2, not greatly strengthen the securities market by reduction of accumulating interest?

ANSWER: There is no question about the fact that a corporation with a small funded debt is stronger and better able to withstand a storm than one with a relatively large debt. I am not prepared to say categorically (for I don't think one can generalize on the subject) what is the proper ratio. I think it depends on the particular industry, on the particular company, and on many other factors. But generally speaking, I think that when corporations can reduce their debt, they are usually very well advised to do so.

QUESTION: If banks can do by themselves what you say they can, why did not the bankers heed the warning of the late Paul Warburg early in 1929, and thus avoid in part the catastrophe of November, 1929?

ANSWER: There is no doubt that we would all be much better off if banks and many others had heeded the warning of Paul Warburg, but in that connection it is a very interesting thing to remember that several times Federal Reserve banks wanted to put the brakes on during the boom by raising their rediscount rates and were prevented from doing so by the Federal Reserve Board in Washington. What I am trying to bring out now, and I think it is something we ought not to lose sight of, is that the excesses of the pre-depression period were not entirely due either to banks or to business, but were to some extent due to politicians.

QUESTION: Has not the tendency toward undercapitalization a great deal to do with the faults, and is it not an evil?

ANSWER: I think it is a very great evil, and I think that faulty corporate structures have had a lot to do with the grief that we have been going through. Anything which will serve to improve the standards in this regard and to strengthen corporate set-ups will contribute a great deal toward avoiding a recurrence of the difficulties which have been experienced in recent years.

The Value of Independent Audits and What the Banker Expects of the Accountant

By CLEAVELAND V. CHILDS, Vice President
of the MANUFACTURERS NATIONAL BANK OF TROY, N. Y.

FOR many years it has been my privilege to maintain rather close contacts with the members of the profession of accountancy and I keenly appreciate the honor of being invited to take part in this first regional chapter conference of your Society. In the days when audits were the exception rather than the rule, I entered upon an energetic campaign among the clients of the firm with which I was then connected to induce them to give us audited statements. Whereas, at the outset few employed accountants, eventually practically all did so. So widespread has the use of audits become that it is hard to realize that as recently as 1929, fewer than half of the companies whose securities were listed on the New York Stock Exchange issued audited statements. By 1933 their number had grown to 80 per cent and now an audit is a prerequisite to the listing of new flotations.

For some years I was a member of the Robert Morris Associates committee on cooperation between accountants and bankers. My interest in encouraging audits is as great today as it ever has been for my bank is in complete accord with the policy of the Marine Midland Group, of which we are members, in seeking the most approved banking practices including the use of independent auditors by our clients. The advantage of such a course is twofold, affecting the client on one hand and the banker on the other. Audits make it possible to stop waste, errors and leakages, detect dishonesty, develop systems designed to increase turnover, improve efficiency and consolidate information indicative of current trends and future possibilities.

I recall during the early years of the income tax, the case of a merchant who had a profitable business of very liquid character, who upon engaging a public accountant at my sug-

gestion, discovered that he had overpaid his income tax for the previous year and he recovered $5,000. from the United States Government.

Now while there has been a tremendous growth in the use of audits, it nevertheless is true that there is still an enormous field open for development. There are still many substantial concerns who use no auditors, or use them only at infrequent intervals apparently with the single purpose of detecting dishonesty. I have in mind an important enterprise of this character which used one of the most outstanding firms in your membership, but allowed them only very limited scope. It became my privilege to develop friendly relations with a director of the company and from time to time as opportunity presented itself to call his attention to the advantages of a real audit for his own protection as well as that of the other stockholders. Eventually, under his influence the company engaged the same firm to make a detailed audit, and this audit developed opportunities to improve methods to an extent sufficient to permit annual savings of several times the cost of the audit.

Small Enterprises also Need Audit

Again, there are many modest enterprises which have never had an audit — small merchants and some fairly sizeable ones who are greatly in need of your services. Concerns of this type, although existent in the metropolitan area, probably do not come to the attention of those of you whose work is centered there, but they afford a very real field to accountants practicing outside of the largest centers. For example, the bookkeeper for such a merchant called on me recently with her employer's balance sheets, profit and loss statement and surplus accounts and was unable to explain why this year's surplus reconcilement did not begin where last year's left off, so I told her to obtain her employer's permission to call on a certified public accountant, showing him the statements, stating the problem, and requesting an estimate of about what it would cost to have him send over a man to review the books. That merchant was a very moderate borrower and always on adequate collateral, and there-

fore not one upon whom undue pressure could be exerted. Yet I felt that if a beginning could be made it might lead to a more comprehensive examination which would in the end abundantly justify itself.

While a detailed audit of financial condition and transactions is the goal toward which we should work and short of which we should discourage clients from falling, nevertheless, much good is derived from tests of transactions, and from a review of operations and even from a simple balance sheet audit where it is clearly so stated in the certificate. It is important to bear in mind also that the expense of detail audits is often greater than the small merchant's business can stand; yet outside of the metropolitan area much can be done for the small merchant by a public accountant who understands his problem and is equipped to handle his case economically. In such cases the accountant will be performing a real service if he prepares a balance sheet, profit and loss statement and surplus account from the books and records without detailed audit, for his classification of the various items will be correct and at least a skeleton of the desired information will be available including the amount and terms of the mortgage indebtedness, the varying character of the current liabilities and whether the records are adequate and the business activities shipshape.

Because your Society has organized up-state chapters, I have dwelt to some extent upon the problem of the small merchant. However, these communities are also the headquarters of many of our most important industries, and in them are to be found clients of every size, class and description. It is, therefore, proper to consider what it is desirable to expect of the accountant who audits such concerns. In general, we desire the report to touch on the history, antecedents and nature of the business, the officers' duties and salaries, any unusual features of the business such as abnormal credit terms, absorption of output or trade policy and specifically to include comparative balance sheets, comparative earnings and surplus statements and detailed profit and loss accounts as well as a detailed balance sheet as of the fiscal closing date. The balance sheet should subdivide

and classify the assets and liabilities, segregating trade receivables from accounts of officers, directors, stockholders and employees and affiliated and subsidiary companies, ageing the receivables and segregating those more than a year old or providing an adequate reserve to cover them. Receivables assigned or hypothecated should be so shown. Merchandise should be taken on the same basis at beginning and end of each period and the basis stated.

The time may come when crews of independent inventory takers may be used by auditors but that time has not yet arrived and it is not feasible to require that type of service which would enable the accountant to certify of his own knowledge as to the quantity, quality or condition of the inventory. For this information he is dependent on the management from whom he should require signed certifications which he can supplement by his own tests. The accountant, however, is responsible for the clerical accuracy and price basis of the inventory and should check purchase invoices with merchandise on hand to a sufficient extent to satisfy himself. If merchandise and corresponding accounts payable are excluded from the balance sheet they should be covered in a footnote, but it is far better to include them on both sides of the statement. Purchase contracts should be examined and if significant should be included in the contingent liability footnote or in the accountant's certificate. The balance sheet should indicate the surrender value of life insurance and the report should include the other details of face value, type of policy, liens and assignees.

The basis of valuation of fixed assets should be covered, indicating whether they were acquired for cash or by issuing capital stock. Any securities owned should be listed. The payables should be segregated to indicate liability for borrowed money, for trade purchases, for taxes and whether current or additional against previous periods, for deposits of officers and others for mortgage or funded indebtedness, for amounts due to affiliated or subsidiary companies. Capital stock should of course be shown, and a subdivision of surplus as between earned and capital surplus. The report should list the officers and directors with the amount of capital

stock held by each. Maximum and minimum debt during the period under review should be shown with the dates. If there are substantially owned subsidiaries, the individual statement should be supplemented by a consolidated balance sheet of the same date.

Accountant Should Advise on Budgets

When a client requests a loan, the banker ascertains its purpose and the method by which it is proposed to be repaid — in other words, a program. Applied broadly to the accountant's work, this means a budget. Clients should be urged to provide budgets and should make use of the certified public accountant in setting up the necessary machinery to compile operating and cash budgets for the ensuing half-year or year.

The accountant's certificate is a vital part of the balance sheet and is scrutinized by the banker. It should indicate the scope of the examination and include any comments that may be pertinent respecting contingent liabilities, abnormal commitments, pending litigation, and other matters not elsewhere covered on the balance sheet.

In general, the certified public accountant should be permitted to serve his client as an advisor because of his familiarity with the client's affairs and by reason of his background of observation and experience.

You have asked me to indicate what the banker expects of the accountant. I have done so, but I wish you to know that the banker realizes that the extent to which his expectations will be fulfilled will be in a degree measured by the scope of the examination permitted by the client. The banker, therefore, will cooperate with the accountant in encouraging as wide a scope as possible.

Presented at the First Regional Chapter Conference of The New York State Society of Certified Public Accountants held at Skaneateles Lake, N.Y., on June 29, 1934.

Index of all Articles which have appeared in the Quarterly and Special Bulletins

		Bulletin
The Real Estate Bond Problem	Francis K. Stevens	*July, 1932
Present Day Problems in Real Estate Finance	Max Fink	"
The Valuation of Real Estate on the Balance Sheet	Leonard Levine	"
Some Real Estate Accounting Problems	Ernest Willvonseder	"
The Balance Sheet of Building and Real Estate Companies	George W. Perper	"
Foreword	Charles J. Maxcy	*October, 1932
Errors—Their Prevention and Detection	S. Carlton Kingston and Lewis Gluick	"
Function of Professional Accountants in Planning and Installing Machine Methods	J. Andrew Crafts	"
Auditing of Punched Card Records	William R. Donaldson	"
Auditing of Records Kept by Cashier Type Machines	Jacob Bennett	"
Cooperation Between Certified Public Accountants and Bookkeeping Machine Manufacturers	Justin Jacobs	"
The Disposition in the Accounts of Abnormal Losses		January, 1933
A Discussion by	Walter A. Staub and William H. Bell	"
With an Introduction by	A. S. Fedde	"
Some Aspects of the Canadian Banking System	Andrew Stewart	April, 1933
Is Specialization in the Practice of Accountancy a Desirable Development?	Morris C. Troper	"
Gold and Inflation	John T. Madden	*July, 1933
Meaning of a C.P.A. Certification on a Bank Customer's Statement	Philip S. Suffern	"
Machine Accounting for Real Estate Management Organizations	J. Andrew Crafts	*October, 1933
Accounting Equipment for Insurance Companies	S. Carlton Kingston	"
Photographic Accounting Machinery	Justin Jacobs	"
Some Observations on the Use of Accounting Machinery	Lewis Gluick	"
Joint Session of Credit Executives and Certified Public Accountants		*January, 1934
The New York Certified Public Accountant Syllabus	Norman E. Webster	*April, 1934

		Bulletin
Ethics in Relation to the practice of Accountancy	Myron A. Finke	*April, 1934
Legal Relationship of an Accountant to an Investor	H. Theodore Sorg	*July, 1934
Investment Banking Phases of the Federal Securities Act and the Securities Exchange Act	Hugh Knowlton	"
The Value of Independent Audits and What the Banker Expects of the Accountant	Cleaveland V. Childs	"

Special Bulletins

Technical Monograph No. 1 Accountants' Reports. A report of the Technical Committee on Accountants' Reports of The New York State Society of Certified Public Accountants		*January, 1927
Relations Between Accountants and Bankers. (Discussion with Committee of The Robert Morris Associates at a meeting of The New York State Society under the direction of the Society's Committee on Cooperation with Bankers and Other Credit Grantors.)		*November 16, 1931
Some Data relating to Audits by Independent Public Accountants of the Financial Statements in the 1931 published Annual Reports of Corporations with stocks listed on the New York Stock Exchange		*October 1, 1932
Tentative Classification of Accountancy Services		*January 12, 1933
Addresses and Discussion Relating to the Federal Securities Act and Accounting Requirements Under the National Industrial Recovery Act	Dr. James M. Landis Malcolm Muir	*October 30, 1933

* Surplus on hand.